In the Supreme Court of the United States

October Term, 1976

No. 76-843

CASCO BANK & TRUST CO. and
RITA B. PRESTON, CO-EXECUTOR and
CO-EXECUTRIX OF THE ESTATE OF
WILLIAM A. PRESTON, JR.,
PETITIONERS,

v.

UNITED STATES,
RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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Petitioners, Casco Bank & Trust Company and Rita B. Preston, Plaintiffs - Appellants below, pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the First Circuit which was entered on September 21, 1976.

Opinions Below

The opinion of the District Court for the District of Maine on the issue raised in this Petition is not officially reported, but it is unofficially reported at 75-1 U.S. Tax Cases (CCH) ¶9290 (1975) and is reproduced at pp. 14-21 of the Appendix hereto (App.). The opinion of the Court of Appeals (App. pp. 22-35) has not yet been officially reported.

Jurisdiction

The decision of the First Circuit, affirming the decision of the District Court, was entered on September 21, 1976. This Court's jurisdiction is invoked pursuant to 28 U.S.C. §1254(1).

Question Presented

Whether, notwithstanding this Court's decision in *Putnam* v. *Commissioner,* 352 U.S. 82 (1956), losses sustained by a shareholder-indemnitor in discharging indemnified corporate obligations may be treated as contributions to capital under I.R.C. §165 rather than as bad debt losses under I.R.C. §166.

Statutes and Regulations Involved

The following statutes and regulations are involved: Internal Revenue Code §§165, 166, 26 U.S.C. §§165, 166; Treasury Regulation §1.166-1(c), 26 C.F.R. §1.166-1(c). The text of pertinent parts of the statutes and the regulation is set forth at pp. 36-38 in the Appendix hereto.

Statement of the Case

This is an action brought by petitioners Casco Bank & Trust Company and Rita B. Preston, as co-executor and

co-executrix of the estate of William A. Preston, to recover payment of a deficiency of $57, 431. 57 in tax and interest assessed against them by the Commissioner of Internal Revenue for the calendar year 1968. The facts of the case may be summarized briefly.

William A. Preston, the decedent, had been engaged in the construction business since his discharge from military service in 1946. In 1948, he formed a partnership with William E. Maloney, Jr. and the business was conducted under the name Maloney & Preston. When the partnership was dissolved in 1964, Preston operated Maloney & Preston as a sole proprietorship, specializing in the construction of public facilities. In June 1968, Preston incorporated the business and contributed $20,000 in capital investment and $13,752 worth of equipment. Preston was issued fifty-one shares of stock, his wife and attorney one share each. From 1968 to 1971, both Mr. and Mrs. Preston were employed by Maloney & Preston, Inc. on a full-time basis and their compensation from the corporation constituted their sole source of livelihood.

To pursue the business of constructing public facilities, Maloney & Preston, Inc. was required to post bid and performance bonds. When Maloney & Preston was incorporated in 1968, the Maine Bonding and Casualty Company required Preston and his wife to sign an indemnity agreement before any bonds would be issued to the new corporation. The agreement provided, in essence, that Maine Bonding would issue bid and performance bonds to the corporation, but if the corporation defaulted on its obligations, the bonding company would be indemnified by the Prestons in their individual capacities for any losses.

In 1970 and 1971, unforeseen complications arose on the corporation's major construction projects. By the summer of 1971, the corporation had defaulted on many of its obligations. The bonding company learned of the situation

and a meeting was held with Preston, his attorney, a claims adjuster from the bonding company, the vice-president of the bonding company, and the company's attorney. The parties arrived at the "general understanding" that Preston would undertake the various outstanding obligations, which he did by advancing $105,807.46 to the corporation. The corporation met most of its obligations and was dissolved by judicial process in 1971. The Prestons applied for and received unemployment compensation.

In their 1971 personal federal income tax return, the Prestons claimed a deduction for a business bad debt of $105,807.46 and a loss on the worthlessness of section 1244 corporate stock in the amount of $33,752.00. The Prestons also filed an application for tentative carryback adjustment based on the unused portion of the claimed 1971 operating loss, requesting a decrease in their federal income tax for 1968 in the amount of $52,023.93. The Commissioner refunded this amount with interest, but later reversed this action and assessed a deficiency of $57,431.57, taxes and interest, which was paid. Plaintiffs brought this action to recover that amount.

Under the statutory scheme of the Internal Revenue Code, if Preston's advances are characterized contributions to capital, the amount of the advances would be added to the basis of his stock. Losses from these transactions, recognized upon the stock's becoming worthless, would ordinarily be deductible only as capital losses. I.R.C. §165(f) and (g). If, however, the advances were debts due Preston from the corporation, they would be deductible as bad debt losses. I.R.C. §166. The tax treatment of these bad debt losses would follow from the determination not reached by the courts below that the debts were either business bad debts (deductible in full from ordinary income) or nonbusiness bad debts (deductible as short-term capital losses).

On March 31, 1975, trial was held before a jury which found in special interrogatories that Preston's advances to the corporation created a bona fide indebtedness from the corporation to Preston, and that Preston's dominant motivation in making the advancement was to further and to protect his business and salary as an employee of the corporation. Upon motion by the defendant, however, the District Judge entered judgment n.o.v. In setting aside the jury verdict, the District Judge disregarded the effect of the indemnity agreement on the transactions at issue and surveyed a number of different factors to hold that there were no "indicia of debt" sufficient to enable a reasonable person to conclude that the advances made by Preston were loans rather than contributions to capital. (App. pp. 17-19) Entry of final judgment was deferred until November 18, 1975 when judgment was entered on another issue in the same case involving deductions for losses on the worthlessness of §1244 stock, an issue not raised in this petition.

On September 21, 1976, the United States Court of Appeals for the First Circuit affirmed the District Court's decision. The Court of Appeals stated that although the District Court had properly looked to several factors in characterizing Preston's advances to the corporation as debt or equity, the District Judge should not have disregarded the effect of the indemnity agreement on the transactions. (App. p. 31) The Court of Appeals nonetheless affirmed the District Court on the ground that no debtor-creditor relationship had been created between the corporation and Preston either at the time of entering into the indemnity agreement or when the advances were made. (App. pp. 31-32) Although the Court of Appeals conceded that a bona fide debt might have been created if Preston had loaned money to the corporation at the time he signed the indemnity agreement (App. p. 31), the Court reas-

oned that the indemnity agreement made it possible for the corporation to obtain bonds which would have been available only if the corporation had been more heavily capitalized (App. pp. 32-33), and therefore Preston's undertaking the indemnity agreement and the performance of obligations thereunder were in the nature of contributions to capital.

Reasons for Granting the Writ

A. The Court of Appeals' Decision Herein Abandons the Principle That Guarantor's Losses Are to Be Treated as Bad Debt Losses Under I.R.C. §166 and Conflicts with the Decision of This Court in *Putnam* v. *Commissioner,* 352 U.S. 82 (1956).

Although the District Judge explicitly disregarded the effect of the pre-existing indemnity agreement on Preston's advances to the corporation, the Court of Appeals recognized that Preston made the advances to discharge his obligations under the indemnity agreement:

> Thus, whether or not the advances to M&P were technically in discharge of his obligations under the indemnity agreement, Preston had to pay; his only choice was as to the form and timing of the payment. It seems unrealistic, therefore, to view the advances in isolation from the indemnity agreement which compelled them. (App. p. 31)

Since Preston's losses were sustained as a direct result of his payments under the indemnity agreement, this Court's decision in *Putnam* v. *Commissioner,* 352 U.S. 82 (1956), is fully applicable to this case. In *Putnam,* this Court held that "the loss sustained by the guarantor unable to recover from the debtor is by its very nature a loss from the worthlessness of a debt." 352 U.S. at 85. Noting that administrative and judicial constructions of the Internal Revenue Code "have always treated guarantors' losses as bad debt losses" (352 U.S. at 86), this Court held that these losses are to be regarded as bad debt losses, deductible as such or not at all. 352 U.S. at 88.

The Court of Appeals, however, declined to follow the rationale of *Putnam.* The Court of Appeals took the view that no debtor-creditor relationship could have been created between Preston and the corporation at the time the indemnity agreement was signed because Preston would be expected to pay only upon the default of Maloney & Preston, Inc. The Court of Appeals therefore concluded that Preston's rights, through subrogation or otherwise, would be more theoretical than real. (App. p. 32) This approach was explicitly rejected in *Putnam.* It is indisputable that the corporation's relationship to the bonding company was a debtor-creditor relationship upon default. The fundamental principle of *Putnam* was that the debtor-creditor relationship is preserved when the guarantor, upon payment, is substituted for the creditor. 352 U.S. 88-89. *See also Horne* v. *Commissioner,* 523 F.2d 1363, 1365 (9th Cir. 1975).

The Court of Appeals also declined to follow *Putnam* on the ground that this Court was not called upon in that case "to distinguish, as we are here, between a business (i.e., fully deductible) debt and an advance in the nature of a capital contribution." (App. p. 33) The Court of Appeals therefore abandoned the approach of *Putnam* and concluded that Preston's advances were deductible only under I.R.C. §165 rather than under I.R.C. §166. In fact, however, neither the District Judge nor the Court of Appeals reached the issue of whether Preston's losses were business bad debts (fully deductible) or nonbusiness bad

debts (short-term capital loss). *Putnam,* in short, was distinguished on the strength of an issue that neither the Court of Appeals nor the District Judge decided.

Most significantly, however, the decision of the Court of Appeals represents an interpretation of the statutory scheme in direct conflict with *Putnam. Putnam* held conclusively that guarantors' losses were to be treated as bad debt losses, "deductible as such or not at all." 352 U.S. at 88. The approach of *Putnam* thus ensures common treatment of guarantors' losses as bad debt losses, and the statutory scheme allows either a full deduction or a short-term capital loss, depending on the circumstances of the debt. In the twenty years since *Putnam* was decided, Congress has taken no steps to modify this interpretation of the objectives of the statute. In fact, §23(k) (4) of the 1939 Internal Revenue Code exists materially unchanged in the present I.R.C. §166(d). The Court of Appeals, however, departing from the statutory interpretation of this Court in *Putnam,* has adopted a debt-equity analysis under I.R.C. §165 with no discernible standards to guide taxpayers and courts in the future. Nothing in *Putnam* or in legislative action prompts this new exception to the principle that "the loss sustained by the guarantor unable to recover from the debtor is by its very nature a loss from the worthlessness of a debt." 352 U.S. at 85. If the principles of *Putnam* are to be abandoned, guidance should come from this Court or from Congress.

B. The Decision of the Court of Appeals Herein Is Inconsistent with Decisions of Other Circuits.

Following the decision in the *Putnam* case, the lower courts have had little difficulty in confining guarantors' losses to bad debt loss treatment under I.R.C. §166. In recent decisions, federal courts have consistently followed the

holding of *Putnam* that a guarantor's loss is by its very nature a bad debt loss, and have refused to permit taxpayers to avoid the operation of I.R.C. §166. *See, e.g., Horne* v. *Commissioner*, 59 T.C. 319 (1972), *aff'd,* 523 F.2d 1363 (9th Cir. 1975); *Bert W. Martin*, 52 T.C. 140, *aff'd,* 424 F.2d 1368 (9th Cir. 1970); *Baum* v. *United States,* 326 F. Supp. 32 (E.D. Wis. 1971). Having established in *Putnam* that guarantors' losses must be deducted under I.R.C. §166 or not at all, this Court, in a case involving an indemnitor's losses on bid and performance bonds identical to those in this case, adopted a rigorous standard designed to preserve the objective of I.R.C. §166 that nonbusiness bad debt losses receive short-term capital loss treatment. *United States* v. *Generes,* 405 U.S. 93 (1972); *see French* v. *United States,* 487 F.2d 1246 (1st Cir. 1973). The statutory consistency of the *Putnam* and *Generes* standards has resulted in important practical benefits in the form of a workable and certain guideline for the trier of fact and a uniform approach to the tax treatment of guarantors' losses throughout the circuits. The decision of the Court of Appeals, however, represents a significant departure from these principles in favor of an undefined and confusing standard suggested neither by the decisions of this Court nor by congressional action.

The argument that guarantors' losses should be treated as contributions to capital under a debt-equity analysis rather than bad debt losses under *Putnam* was advanced and later withdrawn by the Government in *Stratmore* v. *United States,* 420 F.2d 461 (3rd Cir. 1970), *cert. denied,* 389 U.S. 951. The Court there followed *Putnam* in accepting the Government's contention that I.R.C. §166 applied not only to debts created by direct loans, but also to those created "by an indirect indorsement or other type of arrangement which creates secondary or primary liability on the

part of a corporate stockholder . . . ." 420 F.2d at 464. *See also United States* v. *Hoffman,* 423 F.2d 1217 (9th Cir. 1970). In contrast to the consistency and certainty of the approach of the *Stratmore* Court under *Putnam,* the Court of Appeals in the instant case has adopted a "debt-equity" analysis which defines no realistic guidelines for voluntary tax reporting or for litigation in disputed cases. The effect of the decision of the Court of Appeals is clearly to lead a settled point of tax law into an area in which there is little consensus indeed. The District Judge, relying on *Raymond* v. *United States,* 511 F.2d 185 (6th Cir. 1975), surveyed eight different factors to determine whether Preston's losses were "debt" or "equity". The Court of Appeals for the Ninth Circuit, for example, has considered eleven items. *A.R. Lantz Company* v. *United States,* 424 F.2d 1330 (9th Cir. 1970). In recent decisions, there has been uncertainty on the weight to be accorded a particular criterion. *Compare J.S. Biritz Construction Company* v. *Commissioner,* 387 F.2d 451 (8th Cir. 1967) (tax avoidance motive is a significant factor) *with Ambassador Apartments, Inc.* v. *Commissioner,* 406 F.2d 288 (2d Cir. 1969) (refusing to follow *Biritz*) *and In re Uneco, Inc.,* 532 F.2d 1204 (8th Cir. 1976) (reversing the District Court and clarifying *Biritz*). As the leading commentators have observed:

> The definitional turmoil at every level of debt-equity classification probably explains Congress's 1969 decision to enact §385 . . ., which authorizes the Treasury to blanket the area with regulations. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶4.02 (3d ed. 1971).

As the Court of Appeals noted, however, regulations have yet to be promulgated. (App. p. 34 n.9) *See also* Note, *Toward New Modes of Tax Decisionmaking — The Debt-Equity Imbroglio and Dislocation in Tax Lawmaking,* 83 Harv. L. Rev. 1965 (1970). The uncertainty is further reflected in differing approaches to the scope of review on appeal. *Compare Estate of Mixon* v. *United States,* 464 F.2d 394 (5th Cir. 1972) *with A.R. Lantz Company* v. *United States,* 424 F.2d 1330 (9th Cir. 1970).

The decision of the Court of Appeals, while leading cases previously governed by *Putnam* and *Generes* into this uncertain area, provides little guidance for taxpayers and courts in the future. The Court of Appeals conceded, for example, that the jury could have found that Preston reasonably believed when he signed the indemnity agreement that the corporation would never be forced to call upon him to meet its obligations. Maloney & Preston, Inc. was a successful enterprise. (App. p. 31) In *Plantation Patterns, Inc.* v. *Commissioner,* 462 F.2d 712 (5th Cir. 1972), *cert. denied,* 409 U.S. 1976, on which the Court of Appeals relied, however, it was stated that a major consideration in the "debt-equity" classification is "whether at its inception there was a reasonable expectation that the business would succeed on its own." 462 F.2d at 723. *Cf. French* v. *United States,* 387 F.2d 1246 (1st Cir. 1973) (circumstances of entering into guaranty rather than circumstances of payment control determination of "dominant motivation" under I.R.C. §166). Similarly, the fact that bid and performance bonds would not have been issued without indemnity from Preston, the basis of the Court of Appeals' decision (App. pp. 32-33), has been held not to be of controlling significance in other cases. *See, e.g., J. Paul Smyers,* 57 T.C. 189 (1971). This consideration seems especially important where bid and performance bonds on multiple construction projects are concerned, as opposed to bank loans used to purchase capital assets. *See Plantation Patterns, Inc.* v. *Commissioner,* 462 F.2d 712, 722 (5th Cir. 1972). Although the Court of Appeals recognized Preston's valu-

able contribution to the success of Maloney & Preston, Inc. (App. p. 23), it did not address the question of whether Preston's experience and reputation in the construction business should be considered in determining the sufficiency of the corporation's capitalization. *Compare Murphy Logging Company* v. *United States,* 378 F.2d 222, 224 (9th Cir. 1967) *with Plantation Patterns, Inc.* v. *Commissioner,* 462 F.2d 712, 723 (8th Cir. 1972). Other cases have not involved I.R.C. §166, but guaranteed obligations generally have not been treated as contributions to capital. *Compare Plantation Patterns, Inc.* v. *Commissioner,* 462 F.2d 712 (5th Cir. 1972), *cert. denied,* 409 U.S. 1076, *with Murphy Logging Company* v. *United States,* 378 F.2d 222 (9th Cir. 1967); *Ackerson* v. *United States,* 277 F. Supp. 475 (W.D. Ky. 1967); *J. Paul Symers,* 57 T.C. 189 (1971); *Santa Anita Consolidated,* 50 T.C. 536 (1968). No discernible standard emerges from the decision of the Court of Appeals to guide taxpayers and courts, and it is clear that the decision of the Court of Appeals, if allowed to stand, will generate rather than diminish uncertainty and error in a voluntary tax reporting system and in future litigation.

Since the continued viability of the *Putnam* doctrine is problematic, it is likely that a full deduction on guarantors' losses, greatly limited under *Putnam* and *Generes,* will be taken and litigated more often. In cases like *Stratmore* v. *United States, supra,* involving issues once settled under *Putnam,* the taxpayer is now free to assert in response to a "contribution to capital" argument that losses sustained on guaranty obligations are not governed by I.R.C. §166 as bad debt losses, but rather by I.R.C. §165(c) (2) (loss incurred on a transaction entered into for profit) or by I.R.C. §162 (ordinary and necessary business expense). The problem *Putnam* and the cases following it seek to remedy will have come full circle.

The refusal of the First Circuit Court of Appeals to follow *Putnam* and its adoption of a "debt-equity" analysis is a step with potentially far-reaching consequences. The case by case development of the "debt-equity" determination has resulted in "definitional turmoil" with no resolution in sight and, in the instant case, has now been applied to an area of tax law once settled by the holding of *Putnam* that guarantors' losses are to be deducted under I.R.C. §166 or not at all. If the *Putnam* doctrine, as followed in other circuits, is to be abandoned for a standard difficult to define and more difficult to apply in voluntary tax reporting and litigation, guidance should come either from this Court or from Congress.

Conclusion

For the foregoing reasons, a writ of certiorari should issue to review the order and opinion of the Court of Appeals for the First Circuit.

Respectfully submitted,

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December 17, 1976

APPENDIX A

UNITED STATES DISTRICT COURT
DISTRICT OF MAINE
SOUTHERN DIVISION

Civil Action 14-110-SD

CASCO BANK & TRUST CO., et als.,
PLAINTIFFS

v.

UNITED STATES OF AMERICA,
DEFENDANT

EXTRACT FROM TRIAL PROCEEDINGS CONTAINING DEFENDANT'S MOTION FOR JUDGMENT N.O.V. AND BENCH RULING OF THE COURT THEREON

Pursuant to notice, trial was held in the above-entitled action before Honorable Edward T. Gignoux, Judge, United States District Court, District of Maine, and a jury, at the United States Courthouse, Portland, Maine, commencing on March 31, 1975. The following proceedings occurred on April 2, 1975, immediately following return of the jury verdict.

APPEARANCES:

For the Plaintiffs:

Roger A. Putnam, Esq. &
Thomas J. Van Meer, Esq.
Messrs. Verrill, Dana, Philbrick,
Putnam & Williamson
Two Canal Plaza
Portland, Maine 04112

For the Defendant:

Daniel J. Dinan, Esq. &
D. Patrick Mullarkey, Esq.
Trial Attorneys, Tax Division
Department of Justice
Washington, D.C. 20530

(In open court at 3:07 o'clock, p.m.)

The Court: Counsel, the Court understands that the defendant, through Mr. Dinan, wishes to make a motion at this time.

Mr. Dinan: Thank you, your Honor. May it please the Court. Pursuant to the provisions of Rule 50(b) of the Federal Rules of Civil Procedure, the defendant moves the Court to set aside the verdict of the jury rendered in this case and to enter judgment *non obstante veredicto* in favor of the defendant.

The Court: Thank you, Mr. Dinan.

Mr. Dinan: May I state, your Honor, in support of that motion the government would make reference to the argument made by it in support of its motion for directed verdict at the conclusion of the evidence of the plaintiff.

The Court: Thank you, Mr. Dinan.

Mr. Dinan: Thank you, sir.

The Court: The Court understands that plaintiffs have no objection to the Court hearing counsel and ruling upon this motion as orally made at this time?

Mr. Putnam: No, your Honor.

The Court: Right. Do the plaintiffs wish to submit anything in opposition to the motion in addition to what they have previously submitted in opposition to the defendant's motion for a directed verdict?

Mr. Putnam: No, your Honor. I would merely refer to Mr. Van Meer's prior presentation to your Honor consistent with Mr. Dinan's prior motion at the end of the plaintiff's case.

The Court: Thank you, Mr. Putnam.

Counsel, as the Court stated in ruling upon the defendant's motion for a directed verdict at the close of the plaintiffs' evidence, the Court is persuaded, after having heard counsel, reviewed the record and reviewed the case law as submitted to the Court by counsel for the defendant and for the plaintiffs, that no reasonable person could have concluded on the basis of the present record that the advances made by Mr. Preston to Maloney & Preston, Incorporated, were loans and not contributions to the capital of that corporation. Inasmuch as the plaintiffs' entitlement to a business bad debt deduction in the amount of $105,807.46 pursuant to Section 166(d) (2) of the Internal Revenue Code is dependent upon a determination that the advances in that amount made by Mr. Preston to the corporation were loans and created bona fide indebtedness rather than constituting capital contributions, the present motion must be granted.

The most persuasive authority presented to the Court is the very recent case of *Raymond* v. *United States of America*, 6th Circuit, No. 74-1575, March 5, 1975, in which a panel of the 6th Circuit, through Circuit Judge McCree, applied to a factual record essentially identical with that presented here the principles enunciated by the Supreme Court in the leading case of *United States* v. *Generes,* 405 U.S. 93 (1972). In the *Generes* case, the Supreme Court, through Mr. Justice Blackmun, pointed out that the determination of whether an advance by a stockholder to a corporation is a loan or a contribution to capital, and if a loan, whether the stockholder's dominant motivation was to further his personal trade or business, must be determined, not upon the basis of the stockholder's self-serving characterization of the nature of the transaction, but upon the basis of objective evidence indicating what the true nature of the transaction was. Applying this principle in

Raymond, Judge McCree pointed out that the taxpayer's statement characterizing the advances in question as loans, standing alone, was insufficient as a matter of law. The Court then went on at some length to demonstrate that, on the basis of the objective evidence in the record, no reasonable person could conclude that a loan transaction was involved.

In the present case, the only evidence supporting the position of the plaintiffs that Mr. Preston's advances to his corporation were loans and not capital investments is: (1) the statement attached to Mr. and Mrs. Preston's 1971 Individual Income Tax return, which obviously was prepared by Mr. Filar, the Ernst & Ernst tax expert, who had conferred with Mr. Preston in January and February 1972 with respect to the preparation of his tax return; and (2) the work sheets prepared by Mr. Bernard, the Ernst & Ernst accountant, listing the advances in question as "amounts due shareholders", which work sheet entries were entered on the corporate tax returns prepared by Ernst & Ernst. With respect to the work sheets, it is significant that the notations on the work sheets characterizing the advances as "amounts due shareholder" were the creation of Mr. Bernard and the advances were not so recorded on the original books of the corporation as kept by Mrs. Preston and her sister. As against these two items of evidence which plaintiffs contend show that the transactions were loan transactions, the record disclosed the following facts, each one of which was noted by Judge McCree in *Raymond* as contra-indicating a loan transaction: (1) No notes or other written evidences of indebtedness were given by the corporation either at the time the advances were made or subsequent thereto. (2) No security or collateral of any type was given by the corporation to Mr. Preston. (3) No interest was to be paid on the amounts advanced. (4) No fixed date or dates were set for the re-

payment of the advances; indeed, there is no record indicating that there was *any* undertaking by the corporation to repay the advances. (5) The corporation was grossly undercapitalized for the amount of business which it was endeavoring to undertake. (6) Very significantly, Mrs. Preston, who made a completely candid and honest witness for the plaintiffs, conceded that at the time the advances were made by her husband, the only hope of repayment was that the corporation might obtain future projects; that the advances were made by Mr. Preston to the corporation with the hope that future earnings of the corporation might produce funds which would not only repay the advances but would insure the continuance of the business and future profit; and, in her words, that her husband was hoping for — was looking to — a return to the halcyon days of 1969 and prior years when he was earning an income of approximately $200,000-$250,000 a year. (7) It is inconceivable that any third person or any outside lending institution would have advanced to this corporation the amounts advanced by Mr. Preston at the times when the advances were made. (8) The timing of the advances, which is significant — the corporation at the time of the advances was in a desperate financial situation; with no funds coming in, a serious cash flow shortage existed. In summary, every objective indication is that Mr. Preston's interest as a stockholder in keeping the corporation alive and solvent was the dominant motivation for his liquidating his personal securities and placing them in the corporation at the risk of the enterprise.

As previously indicated, Mr. Preston's characterization of the transaction as loan transactions, standing alone, is insufficient as a matter of law to establish their status. And on this record, in the absence of any indicia of debt other than the taxpayer's characterization of the transactions in the tax returns, the Court is persuaded that no reasonable

person could have concluded that the advances made by Mr. Preston to the corporation were loans and not contributions to capital.

The defendant's motion for judgment N.O.V. — that is, to have the verdict of the jury on the present aspect of this litigation set aside and to have judgment entered upon this aspect of the litigation in accordance with the defendant's motion for a directed verdict, and therefore in favor of the defendant — is granted. The Court will ask counsel to cooperate with the Clerk in the preparation of a judgment for the defendant against the plaintiffs on this aspect of the litigation dismissing the action with prejudice and, unless the government raises serious objection, without costs.

Pursuant to the provisions of F.R.Civ.P. 54(b), the Court expressly determines that there is no just reason for delay in the entry of final judgment upon this aspect of the case and therefore expressly directs the entry of final judgment as to the claim which counsel have agreed was submitted for determination by jury trial at this time. That claim, the Court understands, is the claim of plaintiffs that Mr. Preston incurred a business bad debt within the meaning of Section 166(d) (2) of the Code in the amount of $105,807.46 in the year 1971. The Court understands that the second issue briefed by the parties, which was as to whether in 1971 Mr. Preston incurred an ordinary and necessary business expense in the amount of $105,807.46 under Section 162 of the Code has been waived by plaintiffs and is therefore not before the Court. The third issue, which is the only issue remaining open, is the question of whether in 1971 Mr. Preston and Mrs. Preston incurred a Section 1244 stock loss with respect to their Maloney & Preston stock. That issue, the Court understands, is being submitted to the Court on cross-motions for summary judgment. The motions have been briefed and a record stipu-

lated, and the Court will assign them for oral argument as soon as the Court's calendar and the convenience of counsel permits.

Mr. Mullarkey?

Mr. Mullarkey: Your Honor, with respect to the entry of judgment pursuant to Rule 54(b) we generally take the position that a suit for a claim for refund for any year is one cause of action with respect to the entire year, and it's not properly divisible under 54(b). I don't know whether opposing counsel has any particular reason why it should be entered under 54(b).

The Court: The Court's only thought was to get the judgment on the record so that the plaintiffs could file their appeal and the matter could be on its way up, but if counsel prefer the Court defer the entry of any judgment until all issues have been determined —

Mr. Mullarkey: We would, your Honor.

Mr. Putnam: We would join with government in that aspect. We would like to wait until your Honor has ruled on the other aspects, and if we are going to have an appeal, take it all at once or make the final decision when all the facts are in and your Honor has finally disposed of all issues before him.

The Court: The only purpose was to —

Mr. Putnam: We can agree with the government on this one.

The Court: The only purpose was to assist you, Mr. Putnam, and also Mr. Dinan and Mr. Mullarkey in getting this matter before the Court of Appeals and determining whether or not Judge McCree was correct and this Court is correct in applying Judge McCree's rationale to these facts.

Mr. Putnam: I think we can work it out and agree on a form of judgment. We would just like to postpone a final

determination until your Honor has dealt with the 1244 issue and then we can look at where we are at that time.

The Court: Then so much of the Court's order as directed the entry of a separate judgment on this aspect of the case under Rule 54(b) is rescinded, and no judgment will be entered until all issues in the case have been disposed of.

Mr. Mullarkey: Thank you, your Honor.

The Court: Is there any respect in which the Court misstated itself in its oral ruling? Mr. Dinan?

Mr. Dinan: No, your Honor.

The Court: Other than in the result, Mr. Putnam, did you notice any —

Mr. Putnam: Other than in the result, no, your Honor.

The Court: It's been a very interesting case, and it there's nothing further —

Mr. Dinan: No, your Honor.

The Court: Fine. The Court will be in recess at this time.

(Whereupon, these proceedings were concluded at 3:35 o'clock, p.m.)

APPENDIX B

United States Court of Appeals
For the First Circuit

No. 76-1051

CASCO BANK & TRUST CO., ET AL.,
PLAINTIFFS, APPELLANTS,
v.
UNITED STATES OF AMERICA,
DEFENDANT, APPELLEE.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MAINE

Before COFFIN, *Chief Judge,*
McENTEE and CAMPBELL, *Circuit Judges.*

Roger A. Putnam, with whom *Thomas J. Van Meer, Charles A. Harvey, Jr., Verrill, Dana, Philbrick, Putnam & Williamson* were on brief for appellants.
William A. Whitledge, Attorney, Tax Division, Department of Justice, with whom *Scott P. Crampton,* Assistant Attorney General, *Peter Mills,* United States Attorney, *Gilbert E. Andrews, Elmer J. Kelsey,* and *James E. Crowe, Jr.,* Attorneys, Tax Division, Department of Justice, were on brief for appellee.

September 21, 1976

CAMPBELL, *Circuit Judge.* Plaintiffs, executors of the estate of William A. Preston, Jr., brought this action for a refund of $57,431.57 in tax and interest assessed against Preston by the Commissioner for the calendar years 1968 and 1971.[1] At issue are deductions claimed by the tax-

[1] The claimed deductions arose in 1971. The refund for 1968 stemmed from a proposed carryback of part of the loss incurred in 1971. Although the deficiency was assessed against the joint return of Mr. and Mrs. Preston, we will refer to Preston as the taxpayer.

payer for a business bad debt and for a loss on the worthlessness of § 1244 corporate stock. On the business bad debt question, a jury found for plaintiffs but a judgment n.o.v. was subsequently entered for the Commissioner by the district court. The § 1244 stock issue was heard on cross-motions for summary judgment and was also decided in the Commissioner's favor.

Plaintiffs appeal from both judgments. On the § 1244 stock issue, after consideration of the briefs and arguments, we are satisfied that the reasoning of the district court was correct. We therefore affirm on the opinion below. We shall address ourselves herein solely to the issue of the claimed bad debt deduction.

I.

William A. Preston entered the construction business in 1946 and two years later formed a partnership with William E. Maloney, Jr., entitled Maloney & Preston (M & P). The partnership was dissolved in 1964 and Preston continued to operate the business as a sole proprietorship, specializing in the construction of public facilities. He incorporated the business in 1968, contributing an initial capital investment of $20,000, but retained certain assets in his own name. Fifty-three shares of stock were issued: fifty-one to Preston and one each to his wife and attorney. In 1971 Preston contributed $13,752 worth of equipment to M & P which was entered in the corporation's books as paid-in capital. Both he and wife were employed full-time by M & P from September, 1968, until November, 1971. Preston ran the business and Mrs. Preston served as the bookkeeper.

Preston was the principal force behind M & P. He did the pricing and bidding for the corporation's contracts and oversaw to a certain extent the work in progress. He was also in charge of M & P's financial affairs: he handled its capital investments, loan accounts, and lines of credit,

and he authorized payment of its bills. In 1968, he reported $220,277.13 income, primarily from the net profits of the sole proprietorship. After M & P was incorporated, Preston's salary was set at $1,000/month for the first three months, and $5,000/month thereafter. He reported $56,050 salary and $45,206 other income[2] on his income tax return for the calendar year 1969; $31,400 salary in 1970; and $13,600 salary in 1971.

As part of the business of constructing public facilities, Preston was required to obtain bid, performance, and payment bonds. His bonding was principally with Maine Bonding & Casualty Co. (Maine Bonding), both before and after incorporation of the business. In 1968, after M & P was incorporated, Maine Bonding required the Prestons individually to sign an indemnity agreement as a condition to issuing any bonds to the corporation.[3] There was evidence that Maine Bonding required this agreement because M & P had very limited resources — only $20,000 in its capital stock account — and therefore virtually no working capital. The agreement provided, in essence, that Maine Bonding would issue bonds on M & P's contracts, but if M & P defaulted on any obligations covered by the bonds, Maine Bonding would be indemnified by the Prestons for losses incurred in making good on its bonds.

Evidence was also presented of M & P's cash flow.

[2] After M & P was incorporated, those jobs which were already in progress were maintained in the name of the sole proprietorship but were completed by the corporation. Net profits from those jobs went to Preston, not to M & P. The net profits from those jobs during the period of M & P's incorporation totalled around $67,000.

[3] When the business was still a sole proprietorship, Maine Bonding had required an indemnity agreement only with Mrs. Preston, Preston himself already being individually liable for M & P's obligations as sole proprietor. The purpose of this indemnity agreement was to ensure that Preston would not attempt to transfer assets into his wife's name and so insulate them from creditors of the proprietorship. Otherwise, Preston's assets were deemed sufficient for Maine Bonding to act as surety without further protection.

Preston would advance cash to the corporation as needed and, as contract payments came in, would withdraw cash which was not needed. No notes or other evidence of indebtedness were ever issued to Preston for these advances, nor was any interest ever charged. These cash advances were recorded on trial balance sheets as "Due Wm. A. Preston".[4] (There were other entries on the trial balance sheets marked "notes payable" to various third parties.) The trial balance sheets were work papers drawn up by M & P's accountant in the course of preparing the corporation's income tax returns. The sheets were based on information gathered from Preston himself and from the books and records maintained by Mrs. Preston. The net figure of these advances and withdrawals was then recorded on the corporate income tax return under the heading "loans from stockholders". The net figures recorded on the returns under this heading were $75,412 as of March 31, 1969; $30,953 as of March 31, 1970; and $28,148 as of March 31, 1971.

In late 1969, M & P began to experience financial difficulties.[5] Although business had been booming, no new jobs were on the horizon and unforeseen complications had arisen in the two major construction projects on which M & P was then working, the Waterville Osteopathic Hospital and the Maine Maritime Academy. Maine Bonding had issued bonds for both these projects. By the summer

[4] The net profits from the sole proprietorship's contracts were also included in this entry.

[5] On M & P's corporate income tax return for its first full fiscal year (April 1, 1969, to March 31, 1970), it reported gross sales of $1,560,742, yielding a gross profit of $123,163. Although gross sales increased in the ensuing fiscal year (ending March 31, 1971) to $1,978,021, M & P suffered a gross deficit of $59,877 and a total net operating loss of $144,403. The corporation was dissolved on December 21, 1971, and on its tax return for the short year ending December 31, 1971, reported a net loss of $57,521 on sales of $26,261.

of 1971, M & P had defaulted on many of its obligations to subcontractors and suppliers. Maine Bonding received a number of calls from the architect in charge of the Waterville Hospital project. He complained that the project was not being completed satisfactorily, that suppliers and subcontractors were unpaid, and that liens had been threatened or filed against the project. George Frame, an officer of Maine Bonding who had dealt with Preston in the past, wrote Preston on June 18, 1971, saying that he had received complaints and urging that the two meet. Preston subsequently met with Frame and others and a "general understanding" was reached that Preston would attempt to finish payment of its obligations and complete the project to the satisfaction of the architect. Preston afterwards personally advanced approximately $94,000 to M & P which enabled it to do so.[6] Mrs. Preston testified that the purpose of the advances was to keep the corporation going in the hope that it would return to the "good years". These advances came out of Preston's personal bank account and out of proceeds from the sale of certain of his investment securities. They were recorded on the corporation's books in accordance with the normal procedure for advances by Preston.

After the completion of the Waterville Hospital, M & P maintained a skeleton crew in the hope that it might obtain new contracts. No work was forthcoming, however, and the corporation was dissolved in late 1971. The net figure listed on the last work sheet as "due Wm. A. Preston" was $105,807.46. This amount was conceded to have been uncollectible at the time of M & P's dissolution. It was deducted by Preston on his 1971 tax return as a business bad debt under § 166 of the Internal Revenue Code.

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[6] There appears to be some discrepancy in the record as to the exact figure, but that dispute is immaterial.

II.

A principal question for decision is whether the advances made by Preston in 1971 to M & P created a bona fide "debt", as that term is understood under § 166, or whether they should be regarded as contributions to capital, since the two are given different tax treatment. Contributions to capital, like gifts, cannot give rise to a bad debt deduction:

> "*Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of section 166 . . . ."

Treas. Reg. § 1.166-1(c). In characterizing an advance as debt or equity, "objective factors are to be considered and given weight under the particular circumstances of the case, along with evidence of the intent of the parties. . . ." In re *Uneco,* 532 F.2d 1204, 1209 (8th Cir., 1976).

As for the respective tax treatments, if the advances were contributions to capital, they would be added to the basis of Preston's stock. His loss from the transaction would be recognized upon the stock's becoming worthless, and generally would be deductible only as a capital loss. § 165(f) & (g).[7] On the other hand, if the advances are

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[7] Section 165, entitled "Losses", provides in part:

"...

(f) Capital losses. — Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) Worthless securities. —

(1) General rule. — If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) Security defined. — For purposes of this subsection, the term 'security' means —

deemed to have created a bona fide indebtedness, they would be deductible as a bad debt loss under § 166.[8] In

(A) a share of stock in a corporation;
(B) a right to subscribe for, or to receive, a share of stock in a corporation; or
(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. . ."

[8] Section 166, entitled "Bad debts", provides in part:
"(a) General rule.—
(1) Wholly worthless debts. — There shall be allowed as a deduction any debt which becomes worthless within the taxable year.
(2) Partially worthless debts. — When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.
(b) Amount of deduction. — For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property. . . .
(d) Nonbusiness debts. —
(1) General rule. — In the case of a taxpayer other than a corporation —
(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and
(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.
(2) Nonbusiness debt defined. — For purposes of paragraph (1), the term 'nonbusiness debt' means a debt other than —
(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.
(e) Worthless securities. — This section shall not apply to a debt which is evidenced by a security as defined in section 165 (g)(2)(C).

that event, a further question would arise — whether the debt may be properly characterized as a business or a nonbusiness bad debt. If business, the loss may be deducted in full against ordinary income; and if nonbusiness, the loss is treated as a short-term capital loss. § 166(a) & (d).

III.

The jury, in answer to special interrogatories, found (1) that the advances created a bona fide indebtedness on the part of M & P to Preston, and (2) that the indebtedness was a business debt. The district court concluded, however, that no reasonable person could have found that the advances made by Preston to M & P were loans and not contributions to capital, and consequently entered judgment in favor of the Commissioner. In so deciding, it relied principally upon *Raymond* v. *United States*, 511 F.2d 185 (6th Cir. 1975), a case disallowing bad debt treatment to a series of advances made to a family corporation by its principals. We agree with the district court that the advances here cannot, under any reasonable construction, be regarded as creating an indebtedness for purposes of § 166. Accordingly, the court correctly disregarded the jury's special finding. *See Brown* v. *Lamb*, 414 F.2d 1210 (D.C. Cir. 1959), *cert. denied*, 397 U.S. 907 (1970).

The only evidence found by the district court that the 1971 advances were loans was (1) the statement attached to Preston's individual income tax return and (2) the listing of the advances as " 'amounts due shareholder' " on

(f) Guarantor of certain noncorporate obligations. — A payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) shall not apply), but only if the obligation of the borrower to the person to whom such payment was made was worthless (without regard to such guaranty, endorsement, or indemnity) at the time of such payment. . . ."

the trial balance sheets referred to above. With respect to (2), the court thought it significant that these characterizations were the creation of Preston's accountant, and that the advances were not so recorded contemporaneously on the corporation's original books and records. The court cited the following evidence as contraindicating a bona fide indebtedness:

"(1) No notes or other written evidences of indebtedness were given by the corporation either at the time the advances were made or subsequent thereto. (2) No security or collateral of any type was given by the corporation to Mr. Preston. (3) No interest was to be paid on the amounts advanced. (4) No fixed date or dates were set for the repayment of the advances; indeed, there is no record indicating that there was *any* undertaking by the corporation to repay the advances. (5) The corporation was grossly undercapitalized for the amount of business which it was endeavoring to undertake. (6) Very significantly, Mrs. Preston, who made a completely candid and honest witness for the plaintiffs, conceded that at the time the advances were made by her husband, the only hope of repayment was that the corporation might obtain future projects; that the advances were made by Mr. Preston to the corporation with the hope that future earnings of the corporation might produce funds which would not only repay the advances but would insure the continuance of the business and future profit; and, in her words, that her husband was hoping for—was looking to—a return to the halcyon days of 1969 and prior years when he was earning an income of approximately $200,000 - $250,000 a year. (7) It is inconceivable that any third person or any outside lending institution would have advanced to the corporation the amounts advanced by Mr. Preston at the times when the advances were made. (8) The timing of the advances, which is significant—the corporation at the time of the advances was in a desperate financial situation; with no funds coming in, a serious cash flow shortage existed."

In deciding how to characterize the transaction, the court below properly surveyed a number of different factors, rather than only one or two. In re *Uneco, supra,* 523 F.2d 1204; *see Brake & Electric Sales Corp.* v. *United States,* 287 F.2d 426 (1st Cir. 1961). However, we think it should not have overlooked the possible effect on this transaction of the pre-existing indemnity agreement. Preston was not in the position of the ordinary stockholder who voluntarily advances money to his insolvent corporation. Under the terms of the 1968 agreement with Maine Bonding, he was ultimately liable for any amounts which the bonding company had to pay out under the bonds. Thus, whether or not the advances to M&P were technically in discharge of his obligations under the indemnity agreement, Preston had to pay; his only choice was as to the form and timing of the payments. It seems unrealistic, therefore, to view the advances in isolation from the indemnity agreement which compelled them.

Even, however, when attention is focused upon the indemnity agreement, we see the entire transaction not as a loan but as a contribution to capital. True, when Preston signed the indemnity agreement M & P was a going enterprise, and we shall assume that the jury could have found that he did not then believe that he would be called upon to indemnify Maine Bonding, since if business remained good, the company itself would be able to meet its obligations. Had Preston loaned money to M & P in 1968, "the genuineness of repayment prospects in the light of economic realities" might have indicated the creation of a *bona fide* debt. *American Processing and Sales Co.* v. *United States,* 371 F.2d 842, 857 (Ct. Cl. 1967).

But Preston did not loan money to M & P in 1968. What he did loan was his personal credit, making it possible for M & P, which was unable to secure bonds on its own credit, to receive the essential benefits of the bonds. Not only was no debtor-creditor relationship created between the company and Preston in 1968, but by the nature of the arrangement, Preston was expected to put up his own money only if M & P should be in default, by which time any right which Preston would acquire against M & P, whether accruing by subrogation or otherwise, would be more theoretical than real. Thus, we do not see the realities of the transaction as at any time based on the creation of a serious debtor-creditor relationship between Preston and his company. We think the true character of the indemnity agreement is similar to the personal guarantee made by a corporate officer and chief shareholder to creditors of the corporation described by Judge Simpson in ***Plantation Patterns, Inc.*** v. ***Commissioner,*** 462 F.2d 712, 722-23 (5th Cir. 1972), *cert. denied,* 409 U.S. 1076 (1973):

> "The guarantee enabled Mr. Jemison to put a minimum amount of cash into New Plantation immediately, and to avoid any further cash investment in the corporation unless and until it should fall on hard times. At the same time he exercised total control over its management. Adding together the personal guarantee of Mr. Jemison to the guarantee of Jemison Investment Company, which was wholly owned by him and Mr. Jemison's control of New Plantation, we think that the result is that Mr. Jemison's guarantee simply amounted to a covert way of putting his money 'at the risk of the business.' Stated differently, the guarantee enabled Mr. Jemison to create borrowing power for the corporation which normally would have existed only through the presence of more adequate capitalization of New Plantation."

Here the indemnity enabled Mr. Preston to make it possible for his company to secure bonds which would otherwise have been available only through the presence of more adequate capitalization or collateral. We do not think the indemnity arrangement, nor Mr. Preston's subsequent actions enabling M & P to pay off creditors after M & P had defaulted, can be viewed as establishing a meaningful debtor-creditor relationship between himself and M & P.

Plaintiffs argue that under ***Putnam*** v. ***Commissioner,*** 352 U.S. 82 (1956), unsatisfied advances made in discharge of a guarantee are, as a matter of law, bad debt losses. It is true that in the course of that opinion the Court stated that administrative and judicial construction of the internal revenue laws "have always treated guarantors' losses as bad debt losses." *Id.* at 86. But we think the Court's expansive language is limited by its context. The issue in ***Putnam*** was whether a guarantor's loss was to be treated as a fully deductible loss under the predecessor to 165(c) (2), or as a nonbusiness bad debt which received only capital loss treatment under the predecessor to § 166(d). The taxpayer urged the former; the Commissioner the latter. In upholding the Commissioner, the Supreme Court ruled, "a loss attributable to the worthlessness of a bad debt shall be regarded as a bad debt loss, deductible as such or not at all." *Id.* at 88. The Court was not called upon in ***Putnam*** to distinguish, as we are here, between a business (i.e. fully deductible) debt and an advance in the nature of a capital contribution. It relied heavily on the argument that its decision, limiting the taxpayer to capital loss treatment, reflected the economic reality of the transaction:

> "The loss [Putnam] sustained when his stock became worthless, as well as the losses from the worthlessness of the loans he made directly to the corporation, would receive capital loss treatment; the 1939 Code so provides as to nonbusiness losses both from worthless

stock investments and from loans to a corporation, whether or not the loans are evidenced by a security. [footnote omitted]. It is clearly a 'fairer reflection' of Putnam's 1948 taxable income to treat the instant loss similarly. There is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in all reason be the same . . . ."

Id. at 92-93. This reasoning supports the Commissioner's argument here that,

> ". . . *Putnam* is viewed as protecting the statutory scheme for the common tax treatment (capital loss) of losses sustained by shareholders in providing financing for a corporation, whether directly by a loan to the corporation or indirectly by a guaranteed loan . . . ."

Since the Supreme Court handed down its decision in *Putnam,* lower courts have considered whether a guaranty of a corporation's obligations by its stockholder is to be treated as a loan or a contribution to capital. *See Plantation Patterns, Inc.* v. *Commissioner, supra,* 462 F.2d 712; *Murphy Logging Co.* v. *United States,* 378 F.2d 222 (9th Cir. 1967); *Ackerson* v. *United States,* 277 F. Supp. 475 (W.D. Ky. 1967); *J. Paul Smyers,* 57 T.C. 189 (1971); *Santa Anita Consol.,* 50 T.C. 536 (1968). *See also E. J. Ellisberg,* 9 T.C. 463 (1947). While these courts have divided in characterizing claimed deductions for losses incurred as a result of such guaranties, they have generally approached the question as one of fact[9] rather than of law:

> "[T]hat the advances were made in the form of guaranteed debt does not, in and of itself, negate their treatment as capital contributions. Whether such debt is to be treated as an indirect capital contribution must be resolved by an investigation of the facts in the light of traditional debt-equity principles."

Santa Anita Consol., supra, at 550. *E.g., John Kelley Co.* v. *Commissioner,* 326 U.S. 521, 530 (1946).

Here we think the facts indicate unmistakably that Preston's execution of the indemnity, followed by his advancements at a time when his company was in financial trouble, were contributions to capital rather than a loan creating a specific debtor-creditor relationship. Preston, to be sure, doubtless hoped, if business improved, to recover those advances in one way or another. As the owner and chief officer of M & P, he could, without difficulty, reimburse himself if the company's condition permitted; but we do not think the dominant character of the transaction was to create a debt under § 166.

Affirmed.

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[9] Congress itself has acknowledged the general factual approach to debt-equity problems. Section 385 of the 1954 Internal Revenue Code, as amended provides as follows:

> "(a) Authority to prescribe regulations. — The Secretary or his delegate is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness.
>
> (b) *Factors.* — The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:
> (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
> (2) whether there is subordination to or preference over any indebtedness of the corporation,
> (3) the ratio of debt to equity of the corporation,
> (4) whether there is convertibility into the stock of the corporation, and
> (5) the relationship between holdings of stock in the corporation and holdings of the interest in question."

The Secretary has not as yet promulgated regulations under the authority granted to him in this provision.

INTERNAL REVENUE CODE OF 1954 (26 U.S.C.):

SEC. 165. LOSSES.

(a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

* * *

(f) *Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) *Worthless Securities.*—

(1) *General rule.*—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) *Security defined.*—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

* * *

SEC. 166. BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) *Partially worthless debts.*—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

* * *

(d) *Nonbusiness Debts.*—

(1) *General rule.*—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) [as amended by Sec. 8, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] *Nonbusiness debt defined.*—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(e) *Worthless Securities.*—This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C).

* * *

TREASURY REGULATIONS ON INCOME TAX (1954 CODE) (26 C.F.R.):

§ 1.166-1 BAD DEBTS.

* * *

(c) *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of section 166. The fact that a bad debt is not due at the time of deduction shall not of itself prevent its allowance under section 166. For the disallowance of deductions for bad debts owed by a political party, see §1.271-1.

* * *
